

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Rudy Graciano on April 18, 2006

DATED: May 5, 2006

On Tuesday, April 18, 2006, David Callaghan of Kroll and Sharon Blaskey and Brian Faerstein of Willkie Farr & Gallagher LLP ("Willkie") interviewed Rudy Graciano on behalf of the Audit Committee. Mr. Graciano was represented by counsel, Jason Lee of Shartsis Friese LLP. Also in attendance was William Haegele of KPMG. The interview took place in a conference room on the third floor of the San Diego City Administration Building and lasted approximately four hours.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with Rudy Graciano, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

Mr. Callaghan began the interview by explaining the circumstances and purpose of the City of San Diego's (the "City") creation of the Audit Committee, noting that information obtained during the course of the interview would be used, if relevant, in our analysis of the issues and would be reflected in an Audit Committee report. Mr. Callaghan stressed the importance of Mr. Graciano being honest and complete in his answers, and informed Mr. Graciano that if he was unclear about any question, he should ask Mr. Callaghan or Ms. Blaskey to clarify. Mr. Callaghan asked Mr. Graciano to treat information discussed during the course of the interview as confidential and not share any questions asked with others.

Ms. Blaskey added that although Willkie does not represent Mr. Graciano, we intended to treat the matters discussed during the interview as confidential until the ultimate release of the Audit Committee's report, after which it seems likely that any privilege attaching to our interview memoranda will be lost. Ms. Blaskey stated that the Audit Committee holds the privilege and could choose to waive if it were deemed to be in the best interest of the City. Moreover, the Audit Committee retains the right to disclose information obtained during the interview to the SEC, the U.S. Attorney's Office or KPMG, as requested.

Background

Mr. Graciano graduated from San Diego State University in December 1987 with a Bachelor of Science degree in business and administration. Mr. Graciano began working for

the City in the summer of 1988, originally working in the Capital Projects section of the Accounting Division of the City Auditor and Comptroller's Office (the "A&C"). While in this position, Mr. Graciano took and passed the Certified Public Accountant examination. Sometime around 1989 to 1990, Mr. Graciano moved to the Audit Division within the A&C. After three years, Mr. Graciano returned to the Accounting Division, taking a job in the Water and Proprietary section. In 1995, he became a Principal Accountant for the Capital Improvements Program, but shortly thereafter moved to the Accounting Operations section, where he served as a Principal Accountant until May 2004. At that time, he took over Phil Phillips' position as Division Manager of the General Accounting Division, a position he holds to this day.

Mr. Callaghan explained to Mr. Graciano that the Audit Committee is most interested in the time period between 1995 and 2003. Mr. Graciano reiterated that, during that time period, he served as a Principal Accountant in the Accounting Operations section of the Accounting Division of A&C. In that position, he had around ten-to-twelve staff members reporting to him directly, four of which were mostly clerical and the rest of which were accountants. Some of these accountants included Cecilia San Pedro, Karen Hernandez, Sarah Mahan, Joe Bashon, and Vicki Tramm. At this point, Mr. Graciano explained the hierarchy of accountant levels: Accountant IVs perform a more supervisory role; Accountant IIIs are considered "lead" accountants and should know how to perform technical calculations; and Accountant IIs and Is are more rank-and-file. As Principal Accountant, Mr. Graciano's general duties mostly consisted of managing the day-to-day operations of the General Fund, overseeing several other special funds, and coordinating the creation of the Comprehensive Annual Financial Report ("CAFR").

Preparation of CAFR

Mr. Graciano explained that each accountant had responsibility over a different fund, including assuring the fund had sufficient money and the fund's journal entries were correct. Toward the end of the fiscal year, each accountant compiled financial statements for their particular fund, though Mr. Graciano noted that each staff member had between thirty and forty funds of which to keep track. These financial statements were then reviewed by supervisory accountants and then coded to be put into the CAFR. Once all the statements for each fund were in the central database, they were distributed to the appropriate section -- Accounting Operations, Enterprise, Capital Projects, Intergovernmental Agencies -- to be converted into Excel spreadsheets by staff.

Mr. Graciano explained that these financial statements constituted the "numbers" aspect of the CAFR; the textual footnotes were prepared by the City's independent auditor at the time, which was Calderon, Jaham & Osborn ("CJO") (until 2003). Mr. Graciano stated that, by contract, CJO completed most aspects of the footnotes. CJO worked closely with the Executive Secretary of the A&C (Marian Thompson), which Mr. Graciano noted was basically City Auditor and Comptroller Ed Ryan's secretary.

Mr. Graciano explained that he and his staff would gather relevant information from the past year and provide it to CJO upon request. Mr. Graciano said sometimes his staff would provide CJO with background material on how they collected some of the information. Mr. Graciano explained that CJO already had a lot of historical information in their files from

previous years' footnotes, including the supporting documentation for the information ultimately contained in the footnotes. A&C generally did not maintain this historical information in duplicate form. Once CJO received the current year's information from A&C, it would update the previous year's footnotes where necessary, and give the template for the footnotes back to the Executive Secretary, who would then type up the notes to be included in the CAFR.

Mr. Callaghan asked Mr. Graciano if the Executive Secretary was the only person to review the footnotes received from CJO or whether there was some other supervisory official who was ultimately responsible for the content. Mr. Graciano explained that, technically, responsibility would fall on the City Auditor and Comptroller, but the Accounting Division took a lot of ownership over the process. At this point, Mr. Graciano explained the general hierarchy in the A&C in terms of the Accounting Division, listing the chain of command during the relevant period as follows: Ryan; Assistant City Auditor and Comptroller Terri Webster; Accounting Division Manager Phil Phillips; Mr. Graciano and other Principal Accountants. Mr. Graciano noted that Hernandez, who reported to him, was the primary contact of CJO in terms of solicitation of information. Once Hernandez fielded a request for information, she would contact the relevant official or accountant to obtain the relevant information and pass it back to CJO. Mr. Graciano explained that, upon request, with regard to the footnotes, he would help provide information about changes in funds or major events such as bond issuances.

Blue Ribbon Committee Report

Mr. Callaghan showed Mr. Graciano two articles from the San Diego Union-Tribune: "City Has a Deal, But Will Pension Trustees Buy It?", dated June 21, 1996; and "City Finances Called Sound, But New Revenue is Needed," dated February 28, 2002 (Exhibits 1 and 2). Mr. Callaghan asked Mr. Graciano to glance through the articles, and then asked Mr. Graciano about his understanding of and involvement in the Blue Ribbon Committee ("BRC") investigation. Mr. Graciano explained that he worked closely with Holly Reed-Falk in providing the BRC with information about the General Fund, pulling most of the historical information from the fund's financial statements. Mr. Graciano explained that this information was very high-level, mostly related to public safety expenses and sales tax revenue and not specifically concerning the pension fund. He could not recall exactly when he did this work, but thought it was sometime in 2001.

Mr. Graciano noted that Webster was very involved in the information gathering process, as was San Pedro because they worked so closely together. Ms. Blaskey asked Mr. Graciano whether he recalled a lot of buzz surrounding the BRC's investigation. Mr. Graciano recollected that it was a "big deal" and priority for Ryan and Webster. Mr. Callaghan asked Mr. Graciano whether he gave the information about the General Fund directly to Ryan and Webster. Mr. Graciano could not specifically recall the process, but thought that he may have given it to Reed-Falk first.

Mr. Callaghan referred generally to two more articles from the Union-Tribune dealing with pension issues (though Mr. Graciano did not ultimately read them): "Pension Fund Lost Millions Last Year," dated April 5, 2002; and "With Eyes On Stocks, City Seeks Retirement Funding Shift," dated July 11, 2002 (Exhibits 3 and 4). Mr. Callaghan asked Mr. Graciano how the Accounting Division's work for the BRC related to pension issues. Mr.

Graciano explained that Mike Phillips was in charge of retirement accounting, and San Pedro, who worked under Phillips, later took over this position. Webster would contact them directly on these issues. Mr. Graciano had very little interaction with them in this regard. Mr. Graciano recalled that Webster would sometimes say "pension is heating up" and put San Pedro full-time on this issue. Mr. Graciano explained that this was a point of frustration for him, as Phillips or San Pedro would often be tied up with these issues and would not fill him in on the substantive detail. Mr. Graciano could not explain from where these pension issues arose.

Mr. Callaghan asked Mr. Graciano if his work doing analysis for the BRC Report gave him any insight into problems with the San Diego City Employees' Retirement System ("SDCERS"), to which Mr. Graciano responded it did not. Ms. Blaskey asked Mr. Graciano if he read the BRC Report. He said that he did but did not believe that it was misleading or inaccurate. In fact, he had long felt that the City had not made building a sufficient reserve within the General Fund a high enough priority. Ms. Blaskey asked Mr. Graciano if he perceived others in the City were concerned by the Report. Mr. Graciano simply stated that it was a big matter for Ryan and Webster, but he did not perceive any substantial interest in the BRC Report beyond them. The only impact the Report had on him was in the urgency with which they had to gather data and provide information, as meeting the deadlines was a major priority for Ryan and Webster. He could not remember a time when the analysis for the Report slowed down or stopped. Ryan, Webster and Phil Phillips never explained to Mr. Graciano why the Report was so important to them.

Corbett and Other Contingencies

Mr. Graciano recalled general discussions about the *Corbett* litigation, but could not remember the specific issues involved. Mr. Callaghan asked him about which person or group in the Accounting Division would deal with pending litigations. Mr. Graciano explained that A&C would work with the City Attorney's Office to obtain information about litigations and other contingent expenses for the purpose of determining what should be included in the CAFR. The City Attorney's Office would issue this information through an "Attorney Letter," which was sent to both the independent auditor and A&C. Phil Phillips received the Attorney Letter at A&C, and he would generally give it to Mr. Graciano and Hernandez to examine what potential claims and liabilities there were for the year. Mr. Graciano noted that the Attorney Letter was not very comprehensive in explaining how likely it was that a given contingency might come to fruition. Rather, it was merely an inventory of ongoing claims. Ms. Blaskey asked Mr. Graciano if there was another database A&C could consult if the Attorney Letter did not provide sufficient information. Mr. Graciano explained that there was not and they simply would have to inquire further with the City Attorney's Office for more information.

Mr. Graciano explained that, more often than not, it was the independent auditor that actually made the decision about what to include from the Attorney Letter in the CAFR footnotes. Mr. Graciano could not recall the independent auditor asking the Accounting Division for their input. Asked whether he believed that his office should have had more of a role in these decisions, Mr. Graciano explained that he thought his office received the Attorney Letter as "more of a FYI type of thing." However, he could not recall anything on any of the letters they received ever being "skipped over."

Mr. Callaghan showed Mr. Graciano the 2001 City of San Diego CAFR (Exhibit 5). Mr. Callaghan specifically pointed to the section of the CAFR where pending litigations are disclosed and asked Mr. Graciano whether the information in the CAFR would have been everything that was in that year's Attorney Letter. Mr. Graciano explained that the Attorney Letter would have listed more litigations and contingencies, but that he would consider the list in this CAFR as being complete. Ms. Blaskey asked Mr. Graciano how his office knew which items in the Attorney Letter the independent auditor decided to include. Mr. Graciano responded that they generally did not know what ended up getting disclosed and there was not a process by which the Accounting Division would verify the thoroughness of the independent auditor's determination. Mr. Haegele asked Mr. Graciano how he could be sure that the disclosed list in the CAFR footnotes was complete. Mr. Graciano conceded that the Accounting Division would not really know how complete the list was unless there was a glaring omission, i.e. front-page news. Mr. Graciano explained that it would have been Phil Phillips' job to verify the completeness of the list and he would have been the person ultimately responsible for such an omission.

Indemnification of SDCERS Board

Mr. Callaghan asked Mr. Graciano about his general understanding of the SDCERS Board indemnification provision that was part of MP-2. Mr. Graciano could not recall this provision. Mr. Graciano believed that, within his circle at the Accounting Division, people did not pay attention to the events taking place at the City Council or at SDCERS Board meetings until 2004. He explained that he did not believe that Mike Phillips or San Pedro, who were most responsible for retirement issues, paid much attention to SDCERS Board meetings, even when Webster would discuss issues on the SDCERS agenda.

Budget Issues

Mr. Callaghan asked Mr. Graciano about his working relationship with and general impressions of Ed Ryan. Mr. Graciano believed that Ryan had a temper and was difficult to work with, demanding that everything be done immediately. Mr. Graciano explained that Ryan was very upfront about what he thought of his colleagues, discussing such matters openly in front of other employees. However, Mr. Graciano stated that he got along decently with Ryan, as he generally tried not to rock the boat. Notably, Ryan would often bypass Phil Phillips and speak with Mr. Graciano about a number of issues, and Mr. Graciano noted that he and Ryan would speak on a daily basis.

Mr. Graciano recalled that Ryan would sometimes take actions that would otherwise have fallen within the purview of the City Manager's Office. For example, Mr. Graciano explained that, when Ryan sensed that the City was running into a fiscal urgency and needed to save money in certain funds, Ryan would "mandate" that a department curtail its spending to save a certain amount of money by the end of the year. Mr. Graciano explained that Ryan would mostly take such action with regard to discretionary spending items, such as for books or certain supplies. Mr. Graciano explained that Ryan accomplished this by recording an "impound" or "encumbrance" in a department's books such that the department was required to save the stated amount in its budget by the end of the year. Mr. Graciano recalled that this would lead to savings of between \$1-2 million per year in the General Fund. Mr. Graciano believed

Ryan would look for ways to balance the budget quite actively and became particularly aggressive towards the end of his career.

Mr. Callaghan asked Mr. Graciano what he believed to be "material" in terms of the magnitude of these encumbrances. This discussion of "materiality" was in a non-legal, accounting context (and in particular, in the budget context). Mr. Graciano explained that he believed \$5,000-10,000 of a single line item was material, though he could not speculate as to what others he worked with thought was material. He noted, however, that people with whom he worked thought he was particularly cost-conscious when it came to accuracy. Mr. Graciano did not have an understanding as to what would be material to a department as a whole.

Ms. Blaskey asked Mr. Graciano whether he was comfortable putting in the encumbrances on departmental spending or whether he thought this process overstepped the bounds of A&C's authority. Mr. Graciano explained that the encumbrance was ultimately lifted at the end of the year, and A&C had the authority to make sure that there was a balanced budget. Nonetheless, Mr. Graciano acknowledged that the City Manager's Office should have been in charge of the day-to-day operations of managing the budget. Mr. Graciano noted that he believed that City Manager Michael Uberuaga was not very effective in restricting the spending of certain departments. If Ryan believed that he needed to take a role in assisting in this process, Mr. Graciano believed that it was within his overall authority as keeping with the purpose of the A&C.

Mr. Callaghan asked Mr. Graciano about what was causing this overrun in spending. Mr. Graciano explained that the Public Liability Fund was funded exclusively by the General Fund, with around \$6 million deposited into it per year. If certain contingencies came to pass and the Public Liability Fund "took a hit," spending in other areas would have to be restricted. Mr. Graciano specifically stated that depositing \$6 million per year into this fund was "never enough." Mr. Callaghan asked Mr. Graciano who was responsible for creating the budget. Mr. Graciano believed that Uberuaga, Deputy City Manager Bruce Herring and Financial Management Director Lisa Irvine were principally responsible. Mr. Graciano further explained that if, for example, spending by the Fire and Police Departments increased, or the Workers Compensation Fund was "hit hard," holes in the budget were created elsewhere.

Mr. Haegele asked Mr. Graciano about the process of placing encumbrances on spending. Mr. Graciano explained that encumbrances were only put upon spending by the General Fund. Mr. Graciano recalled that when an encumbrance was lifted, savings would be reflected from the money not spent in that particular area of the budget. However, before the books on that fiscal year were closed at the end of June, the Accounting Division made "adjustments" between departmental finances to ensure there were no deficits in the overall finances of the fund. In effect, they would take accumulated savings from certain pools and reallocate those savings to departments in deficit. Asked whether savings were ever carried over as reserves to meet future deficits, Mr. Graciano responded that they were not. Ms. Blaskey asked Mr. Graciano whether the outside auditors understood this balancing process. He believed that they checked the general vouchers and appropriations of the City's finances, but he was not certain whether they looked specifically at what happened before the close of books each fiscal year.

GASB 34 Non-Compliance and Accounting Adjustments

Mr. Callaghan pointed out that, in a prior interview, Mr. Graciano had explained that Ryan had persuaded him once to not comply with certain accounting principles. Mr. Graciano acknowledged that, in 2002, Ryan had persuaded Mr. Graciano and others in the Accounting Division to not immediately implement the changes embodied in the newly-instituted GASB 34.

After some confusion as to the underlying nature of the issue and the individuals involved in the decision, Mr. Graciano clarified that Ryan discussed his decision not to comply fully with the GASB 34 changes with Phil Phillips and Mr. Graciano in or around June 2002. Mr. Lee reminded Mr. Graciano of this conversation with Ryan and Phillips and recommended he discuss it. Mr. Graciano explained that GASB 34 required governments to record all financial activities on a "full-accrual" basis ("government-level") as opposed to a "modified-accrual" basis ("fund-level"). While the former principle focused on an economic-based approach to financial transactions, the latter followed a cash-flow approach and was more malleable in terms of when certain items had to be recognized on a government's financial statements.

Mr. Graciano explained that the City previously had used fund-level accounting for many different aspects of its finances. The City's implementation of GASB 34 required that the City undergo a major reconciliation of its books from fund-level to government-level accounting. They undertook this modification and reconciliation for most aspects of the City's finances, including debt and capital assets. However, Ryan told Phillips and Mr. Graciano that he did not want to implement the GASB 34 changes for the limited purpose of the accounting of revenue, such as sales tax. Mr. Graciano explained that Ryan did not want the City to have to recognize projections of revenue in the present, *i.e.* recognize projected September sales tax revenue in June when they were closing out the books for FY 2002. Ryan knew that if the City did not recognize such revenue on its books in advance, it could carry forward this revenue to when it was actually received on a cash-flow basis and recognize it during the next fiscal year.

Furthermore, Ryan was aware that the City could redefine the "availability period" for the recognition of certain revenue (e.g., from thirty days to sixty days) such that it could book revenue a certain period *after* it was actually received. Thus, when the City needed a one-time infusion of revenue to fill a hole in the budget, it could use this "accounting gimmick" to its advantage. Mr. Graciano recalled that Ryan "played this information very close to his vest." Mr. Haegele later asked Mr. Graciano how he knew that Ryan "remembered" this tool as being available. Mr. Graciano recalled that Ryan would mention it from time-to-time in conversation.

Mr. Callaghan asked Mr. Graciano if Ryan had ever redefined the availability period of revenue prior to the June 2002 discussion regarding the implementation of GASB 34. Mr. Graciano recalled one incident in 2000 when Ryan changed an availability period for sales tax from thirty days to sixty days. Mr. Graciano believed that Ryan discussed this with Phil Phillips and himself, and while he was uncertain whether Webster was also present, he seemed to believe with some assurance that she was. Mr. Graciano explained that he believed that the larger context for this availability period decision was how the General Fund would be projected for that year. The only reason for using this "gimmick" would be to increase the money in the

General Fund, though he noted that he was speculating in hindsight. Mr. Graciano believed that this conversation took place in the second half of 2000, and it was likely when he and Phillips were giving Ryan a report on how the General Fund's finances were not "looking good" at the time. He noted that the fund's finances usually did not look too good (which, he noted, was the norm).

Mr. Haegele asked Mr. Graciano whether Ryan's use of this adjustment to make the fund look better concerned Mr. Graciano at the time. Mr. Graciano responded that it did not, as many other governments at the time used the same type of "accounting gimmick." Ms. Blaskey asked Mr. Graciano whether he recalled the underlying motivation for making the adjustment at that time. Mr. Graciano could not recall understanding the context of the decision. Moreover, Mr. Graciano stated that, even today, he does not see a problem with the use of this type of adjustment in availability period.

Ms. Blaskey asked Mr. Graciano whether it would have been typical for Ryan to speak with Mr. Graciano or Phil Phillips about why a particular accounting adjustment was being made. Mr. Graciano said that this would not have been common, as Ryan was the boss and when he gave a command they would typically implement it. At this point, Mr. Graciano recalled that at around the time of the decision, Ryan alluded to the fact that the "ballpark is heating up." Mr. Graciano did not understand what that meant, but believed it had something to do with "refunds" needing to be done at the time. Mr. Graciano noted that, in retrospect, he wished he had asked more questions about why certain things were done. Ms. Blaskey asked Mr. Graciano whether he believed that he fulfilled his professional obligations as an accountant in undertaking these actions. Mr. Graciano explained that he now has a better understanding of due diligence types of responsibility than he did at the time. Ms. Blaskey asked him when he received his professional license. After acknowledging he had received it during the 1990s, he agreed that he should have known at the time of his professional responsibilities to inquire and be informed about the activities in which he was involved.

At this point, Mr. Graciano was asked to return to his recollection of the decision to not comply with GASB 34 and clarify the impact of this decision and how it was made. Mr. Graciano explained that, when Ryan decided to not immediately comply with GASB 34 in June 2002 with respect to revenues, A&C did not recognize the projected September 2002 sales tax revenue for FY 2002 and carried it forward to FY 2003. Mr. Graciano was asked whether there were other financial entries that were not reconciled with the new GASB 34 requirements. He believed that incidental fines and forfeitures were possibly not modified to full-accrual. However, he specifically noted that property tax was reconciled because they could only define its availability on a thirty-day basis.

Mr. Callaghan asked Mr. Graciano how he knew that the preclusion of revenue from the GASB 34 reconciliation was accomplished. Mr. Graciano explained that the Accounting Division oversaw the preparation of the CAFR and, in his capacity as the principal supervisor of this process for the General Fund, he knew that this piece of information was not included in the 2002 CAFR. Also, Mr. Graciano recalled that he and Phil Phillips had originally informed Ryan that Ryan would no longer be able to use his accounting gimmick of redefining the availability period for revenue because of the new GASB 34 requirements. Ryan responded that he did not want to recognize this revenue and would not do so voluntarily; only if the

auditors mandated this change, he would comply. Mr. Graciano believed that Ryan clearly understood this was a departure from GASB 34, but did not recall having a conversation with Phillips about this decision afterwards.

Ms. Blaskey asked Mr. Graciano if the auditors were aware of the City's non-compliance in this respect or, alternatively, whether Mr. Graciano informed them. Mr. Graciano could not recall whether they knew, but noted that, in retrospect, he "wishes they did." Ms. Blaskey asked Mr. Graciano if he knew that it was within his professional responsibility to inform them about this issue of non-compliance (which seemed to have been significant to Mr. Graciano). Mr. Graciano remarked that he did understand this at the time and that he wishes he had done something, noting that he believed he was rather angry to have been put in that position. Mr. Callaghan asked Mr. Graciano who else knew about the decision not to follow GASB 34 with regard to revenue. Mr. Graciano recalled that Hernandez and Mahan also found out and were rather shocked by the decision, though he could not recall how they were informed. Mr. Graciano acknowledged that Hernandez was the person who would have had the most contact with the outside auditors in terms of answering questions regarding information that needed to be put in the CAFR.

Mr. Graciano was asked when this non-compliance issue was corrected. He believed that it was fixed in January 2003, though he could not recall when KPMG was initially informed about this matter. Mr. Haegle clarified that KPMG did not fully understand this issue until Mr. Graciano's interview with Vinson & Elkins ("V&E") in March 2004.

Mr. Graciano was asked whether the 2002 CAFR stated that GASB 34 had been fully implemented (even though it had not been). Mr. Graciano acknowledged that it did. Further, he confirmed that he, Ryan and other staff in the A&C were aware at the time that this type of new event -- implementation of a new accounting principle -- would be something that would be disclosed in the CAFR. Mr. Graciano explained that he was intimidated by Ryan, could not speak comfortably around him, and worried about his job security if he tried to challenge one of Ryan's commands. Mr. Haegle later asked Mr. Graciano if he understood that GASB 34 was not being fully implemented at the time but was nonetheless being disclosed in the 2002 CAFR as if it were. Mr. Graciano responded that, at the time, he "did not put two-and-two together."

Mr. Callaghan asked if anyone had ever disagreed with Ryan and, if so, what the consequences were. Mr. Graciano explained that he knew Phil Phillips disagreed with Ryan on occasion, usually with regard to minor operational issues. For instance, Phillips would sometimes take offense when Ryan treated a staff member particularly badly. Mr. Graciano recalled that Webster would often step in and be the "peacekeeper" between Ryan and Phillips during their disagreements. However, Mr. Graciano noted that Phillips would generally not challenge Ryan on major decisions, such as what should or should not be included in a financial statement.

Mr. Callaghan asked Mr. Graciano if he recalled employees being transferred or terminated for challenging Ryan's commands. Mr. Graciano recalled one person (Millie Garcia) who was transferred from the Accounting Division, but he could not recall why this occurred. Mr. Callaghan asked Mr. Graciano if anyone ever went up the chain of command in the City to

notify those outside the A&C that Ryan was unreasonable and harassing. Mr. Graciano could not recall whether this information ever made it up to the City Council or other City departments.

Mr. Graciano was asked what other "tricks" Ryan used with regard to accounting practices during his tenure at A&C. Mr. Graciano recalled that Ryan generally had available a list of City funds that showed which funds had large balances, including which funds had few commitments, liabilities or accounts payable. Mr. Graciano recalled one occasion where Ryan "joked" that he wanted to see if the water or sewer funds wanted to invest in the ballpark project. Mr. Graciano believed Ryan was given an updated list of fund balances on a monthly basis, but he was not certain as to how Ryan actually used the information. Mr. Callaghan asked Mr. Graciano whether Ryan ever directed him to take other actions not in compliance with GASB or other accounting principles. Mr. Graciano responded that he had not. It should be noted that, in his prior discussion of the 2002 GASB 34 and the 2000 availability period adjustment meetings, Mr. Graciano appeared to mention a third meeting at which Ryan discussed the use of an "accounting gimmick," but Mr. Graciano did not mention it again and later stated there were only two meetings he could recall where such matters were discussed.

Email Correspondence

After a short break, Mr. Callaghan showed Mr. Graciano a series of email exhibits.

Mr. Callaghan showed Mr. Graciano a November 8, 1999 email from Webster to Phil Phillips and Mr. Graciano regarding the *Corbett* litigation (Exhibit 6). Mr. Graciano was asked about Webster's tone in the email stating that she wanted to talk to Phillips and Mr. Graciano about the litigation but directing them: "do not contact [Jim] Chapin or CERS...just me thanks." Mr. Callaghan asked whether this was Webster's typical manner of communication with him and others. Mr. Graciano did not have a response to this question, though he noted that Ryan was like this in terms of keeping the list of fund balances "close to his vest."

Mr. Callaghan showed Mr. Graciano a November 8, 1999 email from Jim Chapin to Webster inquiring whether the *Corbett* litigation "should be listed from the point of view of the auditor" (Exhibit 7). Mr. Callaghan explained that we believe this email was attached to the above email that was addressed to Mr. Graciano. Mr. Graciano did not recall seeing this email. Mr. Graciano identified "Bob Lawrence," who is discussed in the email, as a payroll assistant accountant. Mr. Callaghan asked Mr. Graciano what "listed" means in the context of the email. Mr. Graciano was not certain, but speculated it may have been in reference to the Attorney Letter prepared by the City Attorney's Office for the outside auditor and the Accounting Division. Ms. Blaskey asked Mr. Graciano whether he believed this meaning would have contradicted his earlier explanation that the Attorney Letter was actually only used by the outside auditor. Mr. Graciano acknowledged that it would. Ms. Blaskey asked Mr. Graciano if he recalled A&C being involved in the settlement of the *Corbett* litigation. Mr. Graciano believed that Webster was likely involved, but he could not be certain.

Mr. Callaghan showed Mr. Graciano a May 5, 2000 email from Webster to Mr. Graciano regarding corrections made to errors in City cash-flow accounting (Exhibit 8). After reviewing the email, Mr. Graciano did not recall it nor did he recall having a discussion with Webster on this topic. However, he explained that when errors were discovered such that certain

revenue was disbursed into the wrong fund, his office would have to make a correction to the distribution of revenue later on. Mr. Graciano explained that, in this email, Webster was discussing whether such corrections should be made known to the rating agencies, which examine the City's revenue information at year end. He acknowledged that this email demonstrated Webster's intention to circumvent actually having to disclose the initial disbursement errors to the rating agencies. Seeking clarity, Mr. Haegele asked Mr. Graciano whether Webster was actually asking him to misstate what had happened with a particular transaction, to which Mr. Graciano responded affirmatively. Mr. Callaghan asked Mr. Graciano if this type of correction was a regular occurrence. Mr. Graciano answered that this was how they would "correct" these types of mistakes. Mr. Callaghan asked how often these errors occurred. Mr. Graciano stated that this only happened once every two or three years, stating that they were not frequent but not isolated either.

Ms. Blaskey asked Mr. Graciano how this information was presented to rating agencies. Mr. Graciano explained that they would show that they actually transacted the cash-flows correctly in the month with the error even though they had not, and they corrected the inaccuracy at a later time. Mr. Haegele directed Mr. Graciano's attention to the bottom of Exhibit 8, which contained Mr. Graciano's initial question to Webster about how they have traditionally made corrections to cash-flow errors. Mr. Haegele asked Mr. Graciano whether he could recall what event prompted this question. Mr. Graciano recalled that he likely was doing monthly cash-flow calculations for the General Fund and saw a large "negative." Realizing something was not accurate, he likely presented the issue to Webster to determine how to go about correcting it. Mr. Graciano again noted that this type of concealed correction was only presented to the rating agencies "once or twice," and these situations did not involve "big dollars."

Mr. Haegele asked Mr. Graciano to read the email again, positing that the language appeared to be of a hypothetical nature and suggest that this was standard operating procedure for this type of disbursement error. Mr. Graciano disagreed with Mr. Haegele, explaining that this practice was only used for "isolated" occurrences. Mr. Haegele asked Mr. Graciano what Webster's use of the phrase "judgment call" meant to him (where Webster wrote that it was a "judgment call" as to whether or not a correction would raise a "red flag due to variance from projections"). Mr. Graciano posited that the phrase meant that if he did not think the mistake was "material" enough to call attention to it and it was just a "Category 2," he should deal with it accordingly. Mr. Graciano explained that a "Category 1" mistake was more conspicuous than a Category 2, which generally would not manifest itself on the monthly cash-flow statement. Mr. Graciano explained that he did not believe the practice was inappropriate at the time. Mr. Haegele pointed out that it would not have been misleading as to the CAFR, but it could be as to the rating agencies, stressing to Mr. Graciano that this would certainly not be considered a "best practice." Mr. Graciano acknowledged this reality, noting that he likely understood at the time that this distorted the financials to some degree. Mr. Lee interjected to ask Mr. Graciano whether he in fact understood this at the time. Mr. Graciano conceded that he did believe at the time that the practice "didn't seem right," and that "it would seem to [him] that the cash-flow is what the cash-flow is." Mr. Haegele asked Mr. Graciano whether, in 2000, the monthly cash-flow statements he prepared would have to be prepared in accordance with GAAP principles. Mr. Graciano acknowledged that he would have known at the time that these

statements -- which did not meet the standards of GAAP -- should have conformed with GAAP principles.

Mr. Graciano was asked whether he recalled Webster asking him to take other accounting actions that he did not believe were correct. He could not recall any such other occurrence, though noted that he did not remember this particular occasion or issue until he was shown the email, so there may be others.

Rating Agency Presentations

Mr. Callaghan asked Mr. Graciano about his general involvement in rating agency presentations. Mr. Graciano explained that he only took part in these presentations if it was in relation to Tax Anticipation Note Series offerings ("TANS"). These presentations were usually in June, and he would only discuss issues related to cash-flows for the year and answer general questions about the General Fund. Otherwise, Ryan and Webster mostly handled these presentations. Mr. Graciano was not certain whether there were additional presentations in connection with non-TANS bond offerings.

Mr. Graciano was asked how information was prepared for the rating agency presentations. He explained that Reed-Falk would collect information about projected budgets and incoming revenues and reconcile and synthesize the information. The rating agencies generally preferred explanations as to why a budget or stream of revenue was projected in a certain way. Mr. Graciano explained that whomever was responsible for a particular fund or department would provide such information, which included Mr. Graciano and his group that oversaw the General Fund. Mr. Callaghan asked Mr. Graciano about the format of the presentations. Mr. Graciano explained that, when he took part in the actual presentation, he never received a script and was never coached. He just used information about "analytical variances" between the previous year's projected budget and actual budget to answer questions. Asked whether he ever recalled representing to the rating agencies that the variances derived from mistakes in recording revenue, Mr. Graciano responded that he did not. Ryan, Webster, Reed-Falk, and Darlene Morrow-Truver most often represented the A&C. He stated that, in addition to the A&C, staff from Financing Services and Financial Management would also be present at the presentations. He noted that Lakshmi Kommi most often represented Financing Services in this capacity.

Interactions with Other City Offices

Mr. Callaghan asked Mr. Graciano if he ever had interactions with elected officials or their staff. He explained that he did not, as A&C was a very rigid environment. He stated that any communications with Council members or media "always" had to go through Ryan or Webster.

Mr. Callaghan asked Mr. Graciano about his interaction with other City offices. With regard to Financial Management, Mr. Graciano explained that he actively worked with them at the staff level and often at the deputy level of the office. With regard to the City Attorney's Office, Mr. Graciano stated that he very rarely interacted with this office, and only at the deputy level. He recalled that he only talked to the office if a City department was making a request to the City Attorney's Office to move forward with preparing the legal documentation for

a particular financial statement, but that he never discussed disclosure issues with the office. With regard to Financing Services, Mr. Graciano recalled that he would primarily interact with Kommi. Mr. Graciano explained that that office oversaw financing efforts by the City and likely initiated most of the bond offerings. He often provided Kommi with information about changes in reserves for rating agency presentations, though he was not certain how such information was used. Mr. Graciano also noted that Financing Services would contact the Accounting Division on occasion and ask them to update certain information in bond offering documents, though this usually only related to numerical changes. He could only recall one occasion that he was asked to look at and change text to an Official Statement. He believed that this instance was in relation to the Workers Compensation Fund.

Interactions with Outside Professionals

Mr. Callaghan asked Mr. Graciano about his interaction with outside professionals. Mr. Graciano recalled that he sometimes worked personally with the outside auditor in preparing financial statements. Specifically, he recalled that in June 2003, he worked with Gary Caporicci and another auditor at Caporicci & Larson -- the City's outside auditor after CJO -- during the preliminary preparations for the 2003 CAFR. Mr. Callaghan asked Mr. Graciano if he ever had any interaction with outside bond counsel Paul Webber. Mr. Graciano recalled being on a conference call with Webber. He recalled that Ryan, Webster, and Morrow-Truver were also on this call, and it involved issues relating to the preparation of the January 2004 Voluntary Disclosure of the errors in the 2002 CAFR. Mr. Graciano recalled that Webber was drafting this section of the Voluntary Disclosure and gave it to Ryan to look over. He could not recall his level involvement on this call.

Diann Shipione Allegations

Mr. Graciano did not recall much about Diann Shipione's allegations regarding the illegalities surrounding the pension system, except that he believed her name surfaced during November and December 2003 when all of the financial disclosure issues were prominent. He explained that he became aware of her general concerns through Webster, who he believed would have been most involved in A&C in responding to Shipione's concerns. Mr. Graciano could not recall doing any investigative work in response to her allegations, though he believed that it was quite possible that Mike Phillips or Cecilia San Pedro was involved in the response.

MP-1 and the Net Pension Obligation

Mr. Graciano explained that he was not familiar with the details of MP-1 in 1996 or thereafter. He recalled that the only thing he knew about the proposal at the time was that the City would be paying less into the pension fund than was otherwise required, the employees would receive increased benefits, and there would be a Net Pension Obligation ("NPO"). Mr. Callaghan asked Mr. Graciano if he had any responsibility in accounting for the NPO. Mr. Graciano explained that his section would have been involved in determining the amount of the NPO, which would then be recorded in the financial statements. He explained that Mike Phillips was the person most involved in supervising this process.

Ms. Blaskey asked Mr. Graciano how he would have learned that there was an NPO. Mr. Graciano explained that Mike Phillips, whom Mr. Graciano believed was very well-

versed in retirement issues, likely mentioned to him that Ryan wanted Phillips to examine the NPO among other retirement issues. He believed this conversation with Phillips took place sometime around 1996 or 1997, though he could not remember if anyone else was involved in this conversation. Asked whether he was aware a reserve was created for the NPO, Mr. Graciano responded that he was not.

Ms. Blaskey asked Mr. Graciano if he had an understanding at that time about what the disclosure obligations would have been with regard to the NPO. Mr. Graciano stated that he would not have, nor does he have a comprehensive understanding to this day. He believed that this was the responsibility of the independent auditor. Ms. Blaskey asked Mr. Graciano whose responsibility it would have been within A&C to communicate with the independent auditor about such disclosure issues. Mr. Graciano could not recall, but speculated that Webster and Phil Phillips would have each stated that the ultimate responsibility fell upon the other person. Mr. Graciano explained that he believed this would have been the case because Webster was intimate with pension issues while Phillips was the foremost accounting expert.

Mr. Graciano stated that he believed Webster was best situated to deal with these specific disclosure issues as she was very keyed into the Retirement System. Mr. Graciano noted that the independent auditor knew that she was the person most involved with pension issues in A&C. Mr. Graciano was not certain how often Webster interfaced with the independent auditor, noting that Phil Phillips generally had more contact than Webster. Mr. Graciano also noted that Mike Phillips or San Pedro may also have been in contact with the independent auditor on pension issues, but Mr. Graciano would not have known because they would have reported back to Webster, not him, about these matters. Thus, Mr. Graciano would likely not have heard about these issues unless they were "non-routine," which he defined as high-profile issues.

MP-2

Mr. Graciano could not recall much about the negotiation or implementation of MP-2. He recalled that his benefits were increased, but could not remember the City's contribution to the pension fund going down at the time. He recalled that he did not make any inquiries about why the funding of the Retirement System was being decreased, as he believed that this was standard retirement policy-making at the time.

Audit Information

Mr. Haegele asked Mr. Graciano about whom in A&C the independent auditor would have sent its list of requests for information at the outset of an audit. Mr. Graciano explained that the list was circulated to everyone in the Accounting Division, and they would divide up the list in terms of each accountant's area of focus, i.e. water and sewer issues would be handled by the accountants charged with overseeing those funds. Mr. Graciano could not recall meetings at which it was decided who would look into each inquiry; rather, it was mostly assumed who would take up each particular issue. Mr. Haegele asked if the list of information requests would go to a central person after each section within the Accounting Division had reviewed its particular issues. Mr. Graciano responded that the information flowed directly back to the independent auditor from each accounting section rather than first through a central hub. He noted that the information provided by the accountants might be reviewed by a supervisor in that particular section, but not necessarily the Principal Accountant for that section. Mr.

Graciano explained that, in his capacity as the Principal Accountant of the Accounting Operations section, he would sometimes glance at information provided by his subordinates, but he was not actively involved in compiling the information or answering the independent auditor's questions. He estimated that he spent only two-to-three percent of his time working with Hernandez in such a supervisory role.

CAFR Disclosure

Mr. Graciano was asked about who was ultimately responsible for CAFR disclosure issues. He answered that A&C was, but that the City as a whole was in a generic sense. He explained that A&C was responsible for having a procedure in place to facilitate the disclosure review process, but that A&C can only be as effective as the information it is provided is accurate.

Mr. Graciano explained the process by which he and Phil Phillips reviewed the documents that the independent auditor returned to the City after preparing the footnotes. Mr. Graciano explained that, on a yearly basis, Phillips and Graciano distributed these documents to the Principal Accountants in the relevant sections. This was not at the direction of Ryan or Webster, but rather a matter of annual process. Mr. Callaghan asked Mr. Graciano if Phillips was his peer in this capacity, or whether Mr. Graciano deferred to Phillips when issues arose. Mr. Graciano explained that he would collect the documents back from the Principal Accountants, which may or may not have contained corrections and comments, and give them directly to the independent auditor, most often without first providing the documents to Phillips for his review. Mr. Graciano noted that not all of the Principal Accountants returned comments and that there was not a step in the process to make sure that the accounting sections actually read the draft footnotes. Rather, it was just assumed at the time that if there were no comments, that section had not found any errors or omissions. Mr. Graciano clarified that, before sending all the comments back to the auditor, he would undertake to examine the comments, determine what the proposed change was and ascertain why it was being made.

Mr. Callaghan showed Mr. Graciano the 2001 CAFR (Exhibit 5) and directed him to the footnotes. Mr. Callaghan asked whether the purpose of the review process described above was just to correct the numerical mistakes in the tables or also to scrutinize the text. Mr. Graciano stated that they also examined the text, noting that he would have looked at the text in the 2002 footnote including the discussion of the implementation of GASB 34. However, with regard to his knowledge of the fact that certain revenue had not been included in the effectuation of GASB 34, Mr. Graciano stated, "I probably didn't even think about the implication of the sales tax, even though I would have reviewed the section that contained the note about the implementation of GASB 34."

Mr. Graciano was asked why he has recently started to review financial statements more carefully. He explained that he has come to better understand the funding principles of the pension system, which led to his questioning of San Pedro about the pension-related GASB issues in 2003. Asked whether his job description changed at some point to include this type of review, Mr. Graciano simply stated that he has been more involved in the process because he has come to better understand it.

Wastewater

Mr. Graciano explained that he was not involved in any of the Sewer bond offerings nor was he involved with rating agency presentations on wastewater issues. Asked whether he recalled what triggered the need for the disclosure of pension issues in connection with the 2003 Sewer bond offering, Mr. Graciano did not know.

Mr. Callaghan asked Mr. Graciano if he had any knowledge about the City's review process for compliance issues in connection with the acceptance of federal and state grants and loans. Mr. Graciano responded that he did not have such knowledge because grants were handled by a different section of A&C. In particular, a sewer grant issue would be handled by the Proprietary section.

Remediation

Referring to the recommendations contained in his interview with V&E, Mr. Callaghan asked Mr. Graciano whether he had any more insight about specific internal control weaknesses that needed to be remedied. Mr. Graciano explained that he believed that the appropriate steps had been taken to ensure that there is an adequate level of expertise in A&C to review the financial statements. Specifically, Ms. Blaskey asked Mr. Graciano whether he had heard of any situations where certain funds earmarked for one purpose were used for another. Mr. Graciano recalled that he was not aware of any such situations.

At the conclusion of the interview, Ms. Blaskey reiterated to Mr. Graciano the importance of keeping confidential what was discussed during the course of the interview, as the Audit Committee sought to ensure that future interviewees would provide candid discussion of the relevant issues. Mr. Graciano acknowledged his understanding of this request.

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